Attn: Kim Hildred
Staff Director
Subcommittee on Social Security
Committee on Ways and Means
U.S. House of Representatives
B-317 Rayburn House Office Building

Questions for the Record of June 21, 2012 Hearing
Subcommittee on Social Security
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Answers of Charles Blahous

I am pleased to offer these answers to Chairman Johnson's questions for the record. If you have further questions or would like additional information, please do not hesitate to ask.

Charles Blahous

Q1: Disability Insurance (DI) provides an essential income safety net for those who are unable to work due to disability, yet this program won't be able to pay full benefits beginning in 2016. The Subcommittee is conducting a hearing series on securing the future of the DI program. Please explain why the Disability Insurance program financing is in worse shape compared to the retirement and survivors program and give us your recommendations for how to secure the DI program.

A1: There are a number of reasons why the DI trust fund is in more immediate financial difficulty than the OASI trust fund. The first one is simply timing: the large baby boom generation became eligible for disability benefits before they became eligible for retirement benefits. Over the very long term, the trustees' projections for annual cash imbalances in the disability program are no worse than they are for the retirement portion of Social Security. But the financial strains that arise from demographics have hit DI first, with the result that DI insolvency is projected for 2016 while OASI is projected to remain solvent until 2035. In future years more disabled baby boomers will convert to retirement benefits, shifting some current DI costs to the OASI trust fund.

Another contributor to the financial difficulties of the DI program has been the rising percentage of women with working careers of sufficient length to render them eligible for disability benefits. Fewer than 55% of women were disability-insured at the time of the 1983 Social Security reforms, whereas today the number is approaching 70%. Disability incidence rates among women have also risen to be closer to those for men.

By the early 1990s it was already clear that the disability program's share of total Social Security taxes was insufficient to finance its share of total program costs. Policy changes (including liberalization of eligibility criteria in 1984) and economic conditions up through the early 1990s drove up disability incidence rates relative to assumptions operative at the time of the 1983 reforms and for several years afterwards. Estimators also failed to anticipate a decline in disability termination rates that was, in the words of the 1992 Trustees' Report, "In part because of the lower average age of new beneficiaries." The higher share of disability recipients who are women, and/or who receive disability benefits on the basis of mental or musculoskeletal disorders, combined to drive down mortality rates among disabled beneficiaries. A reallocation of program tax rates effective in 1994 staved off immediate DI insolvency but was insufficient to restore the long-term health of the DI program. DI was thus in weaker financial condition than OASI even before the most recent recession precipitated additional disability benefit claims.

Options for restoring the DI system to financial health are in some senses more limited than with the OASI program, but in other senses more diverse. Eligibility age increases that can be used to reduce projected OASI costs will not save money in DI (and could actually increase DI costs). DI options thus essentially consist of changes to its benefit formula, eligibility criteria and tax revenue collections. In view of DI's weaker financial condition relative to OASI, I believe a reallocation of the current tax rate to be appropriate, though this would merely strengthen DI at the expense of the OASI program. I would recommend that any changes to the benefit formula be made concurrently to OASI and DI, to avoid "gaming" issues that could arise if the two formulas were decoupled. I believe it is appropriate to explore changes to the bend points or bend point factors so that scheduled benefits grow more slowly in each program than under current law, with the effects of such cost constraints concentrated on higher-income beneficiaries. As I describe more fully in my answer to your third question here, I also believe that reforms should be considered with attention to work incentives, for example by restructuring the benefit formula so that benefits rise proportionally with every additional year of work.

Q2: When Social Security began, the full retirement age was established at age 65. Social Security's early retirement age was first established at age 62 for women in 1956, and for men in 1961. Today, the early retirement age remains unchanged, however the full retirement age will reach 67 for those born after 1959. Had the full retirement age kept up with increases in life expectancy, what would it be today? Was the system designed for people to live as long as they do today?

A2: The precise answer depends on whether we are referring to life expectancy at birth, upon first receiving benefits or at some other age, because historical life expectancy increases have been unequal at different ages. By any measure, however, Social Security's eligibility ages have not risen to keep pace with U.S. population aging. Since Social Security's inception cohort life expectancy at birth has risen by nearly eleven years. Cohort life expectancy at age 65 has risen by about six years. Thus, even if using a more conservative measure of longevity improvements the full retirement age would need to be at least

71 today rather than the current 66, if indeed the policy goal were to have the normal retirement age keep pace fully with increasing longevity.

With respect to the second question as to whether Social Security was originally designed for people to live as long as they do today, my subjective answer is a qualified no. Though Social Security's designers could make reasonable estimates of future longevity gains, they were not in a position to anticipate other factors that affect population aging, including among them the subsequent pattern of changes in fertility rates that is now producing such dramatic increases in the number of people receiving old-age benefits. We must also remember that the benefits the program now pays at a given age are a function of a number of program design elements, including not only the full retirement age but also early-retirement eligibility, automatic annual cost-of-living adjustments, wage-indexing of the initial benefit formula, and various *ad hoc* benefit increases legislated over the decades. One could thus look at this complex picture in either of two ways; on the one hand one could argue that if Social Security was still limited to its original benefit design, current eligibility ages would be sustainable. If however we instead think of Social Security as the program we know it today -- with its COLAs, wage-indexed benefits, and early retirement options -- its original eligibility ages were clearly not designed for a program with these features.

Q3: Before the 1977 Amendments, the only way initial benefits increased was through an Act of Congress, which has happened 11 times. Under the 1977 Amendments, Congress fixed an unintended error resulting from earlier legislation by changing the benefit formula so that initial benefits would automatically increase with wage growth. As a result, today's retirees are receiving larger benefits in real terms than their parents did. Please discuss some of the options whereby benefits could increase at a sustainable rate, better reward work, and still protect lower earners.

A3: I am currently in process of completing a paper that addresses many of these issues. As you note, the 1977 amendments established a benefit formula that is indexed to growth each year in the national Average Wage Index (AWI). Because over time worker wages tend to grow faster than price inflation, this produces substantial growth in the real (inflation-adjusted) value of individual Social Security benefits. This is a significant driver of program cost growth, and if continued without alteration would result in growing tax burdens for younger generations.

Two features of this benefit formula are often overlooked. One is that in an aging society it causes lifetime worker cost burdens to rise over time, which causes benefits to grow faster than pre-retirement *after-Social-Security-tax* earnings. Assuming for example that current benefit schedules are left in place and that taxes are raised to maintain solvency, a worker with steady earnings retiring in 2055 who receives a benefit equal to roughly 41% of his gross pre-retirement wages would have faced a lifetime Social Security cost rate of over 16% to receive that benefit, whereas the worker retiring in 1985 would have faced a lifetime cost rate of less than 6% for that same 41% replacement rate. Thus, even if the policy goal is to maintain benefits that remain a constant percentage of pre-retirement living standards (a goal that would still require substantial tax increases to meet), the current benefit formula overshoots the mark and a downward adjustment to future benefit growth of roughly 0.25 percentage points per year would be necessary.

A second often-overlooked result of the current indexing method is that it produces benefit replacement rates that *rise* over time for a given real level of earnings. For example, the worker retiring in 2055 and earning the CPI-indexed equivalent of roughly $43,800 today is being promised a benefit replacement rate of 48.7%, in contrast with a $43,800 worker retiring today who receives a benefit replacement rate of 42.9%. This implicitly reflects a value judgment embedded in the current formula, which is that as society grows richer the safety net should expand so that Social Security benefits for a worker with a given level of real income automatically grow more generous relative to his cost of living. This is clearly not the only value judgment that could be made. If the method of indexation were changed to pay the same real level of benefits based on the same level of real earnings across time, a substantial portion of the program's projected financing shortfall could be closed.

Your question also asks whether reforms to bring the growth of benefits to sustainable levels could better reward work. I believe that the answer is yes. The benefit reduction applied to early benefit claims, and the reward applied to delayed retirement claims, could both be increased to reflect the value of payroll taxes contributed by seniors who extend their working lives. Moreover as I mentioned in my answer to the first question the existing benefit formula, currently applied to an average of an individual's top 35 earnings years after indexing for national wage growth, could instead be applied to each *individual* earnings year. As an example, the existing benefit formula could be divided by 38 or 40 and then applied to each year of earnings. As a result, in contrast with the current formula where benefit returns drop precipitously when an individual reaches 35 years of earnings, younger seniors would continue to accrue proportional benefits if they extend their working careers. Finally, the growth of the non-working spouse benefit for higher-income earners could be constrained. Under current law it is possible for the spouse of a higher-income individual, who makes no direct tax contributions to Social Security, to receive a higher spousal benefit than the primary benefit another lower-wage individual might receive after a full career of contributing taxes to the program. This situation both undermines work incentives and creates regressive income transfers. This could be addressed by restricting the growth of non-working spouse benefits, so that the most generous such benefits do not exceed the inflation-adjusted value of benefits received by full-career low-income workers in 2012. All of these reforms would improve system finances while improving the returns to work under Social Security.

Q4: As young people often don't think Social Security will be there for them, what advice do you have for what we should tell them? Can they expect to get back what they paid into the system?

A4: Answering the second question first, unfortunately younger workers cannot expect to receive back the present-value of their contributions to Social Security. A table in the Social Security Trustees' report shows that workers just now entering the system should expect on balance to contribute roughly 4.2% of their wages more than they receive in benefits, if current benefit schedules for older cohorts are left in place. This is a consequence of population aging colliding with Social Security's financing methods. Because Social Security benefits are funded primarily by taxing the wages of current workers, and because the ratio of workers to beneficiaries is declining, the lifetime cost burdens facing younger workers are rising. Another analysis of the Social Security Actuary's office shows that individuals born in 2004, if they marry to form a two-earner couple, would expect to receive back only 82 cents on the dollar if taxes are raised to fund currently scheduled benefits.

This income loss does not mean that Social Security would not be there for younger generations or that it would disappear altogether. Having said that, I am on the pessimistic side of most Social Security experts in fearing for the program's long-term future. For several decades the program's foundation of political support has rested on the perception that Social Security is not welfare but rather an earned benefit, self-supporting through its own separate system of worker contributions. Already the long-term Social Security shortfall is substantially greater (even relative to today's larger economy) than the one corrected with such difficulty in the 1983 program reforms. If more than a few additional years pass without legislative correction, the size of the short-term sacrifices necessary to sustain Social Security as a self-financing program will far surpass historical precedent for enactment in legislation. If Congress becomes unwilling to raise taxes or cut benefits sufficiently to keep Social Security self-supporting, permanent subsidies from the general fund may be required. I fear that Social Security's foundation of public support, and its status as a perceived earned benefit, would both be threatened if Social Security were merged into the general budget in such a way.